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ABSTRACT

Certain state or not-for-profit agencies guarantee payment to banks and other lending institutions if students fail to repay loans obtained through the Federal Family Education Loan Program. The 1998 amendments to the Higher Education Act authorize the Secretary of Education to enter into voluntary flexible agreements (VFAs) with individual guaranty agencies, and each VFA provides a guaranty agency with flexibility to implement new business practices by waiving or modifying some federal regulations. As of November 2001, the Department of Education had signed VFAs with 4 of the 36 guaranty agencies in the United States, and five agencies had applied but were not selected, withdrew, or did not reach agreement with the Department of Education. In response to a request from Senator James M. Jeffords, the U.S. General Accounting Office (GAO) looked into the development of VFAs and their implementation. Data came from interviews with Department of Education officials involved in the development of the VFAs and officials at each of the 9 guaranty agencies that applied for an agreement and 10 agencies that did not choose to apply. It was found that the VFA development process did not meet the needs of the guaranty agencies fully. The process was frustrating, in part because the Department of Education did not meet its own timetable. The process for determining VFA selection criteria and inviting VFA proposals was not clear enough. VFAs were generally found to comply with legislative requirements, although in one instance the requirement that VFAs not increase projected federal program costs does not appear to have been upheld. The Department of Education is not fully prepared to assess the effects of the VFAs. The GAO makes recommendations in this report to improve the four current VFAs and the development of additional agreements. Five appendixes contain information about the study scope and methodology, some financial projections, comments from the U.S. Department of Education, and a list of GAO contacts and staff involved in the report. (SLD)

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United States General Accounting Office

GAO

Report to the Honorable
James M. Jeffords, U.S. Senate

January 2002

FEDERAL STUDENT LOANS

Flexible Agreements With Guaranty Agencies Warrant Careful Evaluation

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Abbreviations

FDLP	William D. Ford Direct Loan program
FFELP	Federal Family Education Loan Program
HEA	Higher Education Act
VFAs	voluntary flexible agreements

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United States General Accounting Office
Washington, DC 20548

January 31, 2002

The Honorable James M. Jeffords
United States Senate

Dear Senator Jeffords:

In an attempt to achieve program and cost efficiencies and improve delivery of student financial aid, the relationship between the Department of Education (Education) and state-designated guaranty agencies that administer the nation's largest federally supported student loan program continues to change. These state or private not-for-profit agencies, which guarantee payment to banks and other lending institutions if students fail to repay loans obtained through the Federal Family Education Loan Program, operate under federal regulations issued by Education and agreements with Education. The 1998 amendments to the Higher Education Act (HEA) authorize the secretary of Education to enter into "voluntary flexible agreements" (VFAs) with individual guaranty agencies. Each VFA provides a guaranty agency flexibility to implement new business practices by waiving or modifying some of the requirements established under federal regulations that apply to other guaranty agencies. As of November 2001, Education had signed VFAs with four of the nation's 36 guaranty agencies. Five other guaranty agencies applied, but were not selected, withdrew, or did not reach agreement with Education.

Although the 1998 VFA legislation gave Education flexibility in developing these agreements with the guaranty agencies, it also imposed some restrictions. For example, while the agreements could potentially change almost any aspect of how the guaranty agencies are compensated for services by Education, the VFA legislation prohibited the agreements from increasing projected federal program costs. Additionally, the agreements could change how the guaranty agencies process loans, but the VFA legislation prohibited the agreements from changing the statutory terms and conditions of loans, such as the borrowers' interest rate. Some guaranty agencies and other program participants, such as representatives of lender and loan servicing groups, told us that Education could have done a better job in developing the agreements and some expressed concern that the agreements may not have entirely complied with the restrictions contained in law. You asked us to examine these matters. Specifically, as agreed, we focused on answering the following questions:

1. To what extent did the VFA development process meet the needs of guaranty agencies and other program participants?

2. To what extent do VFAs comply with requirements in the VFA legislation?

3. What changes are being implemented under the VFAs?

4. How well prepared is Education to assess the effects of the VFAs?

For this study, we interviewed Education officials involved in the development of the VFAs as well as officials at each of the 9 guaranty agencies that applied for an agreement and 10 of the guaranty agencies that chose not to apply. We also discussed the VFAs with other program participants, such as representatives of lender and loan servicing groups. We reviewed the four, signed agreements for compliance with the provisions in the VFA legislation. We used Education's analyses to determine whether the VFAs complied with the requirement not to increase projected federal program costs. We performed our work between February and December 2001 in accordance with generally accepted government auditing standards. For details concerning our scope and methodology, see appendix I.

Results in Brief

The VFA development process did not fully meet the needs of the guaranty agencies and other program participants. The overall process, which began when Education invited all guaranty agencies to submit a VFA proposal, frustrated guaranty agency officials we talked to, especially those who ultimately chose not to apply for a VFA and those that were not granted a VFA. Frustrations stemmed, in part, from Education's insufficient communication regarding the VFA development process and its inability to meet its own timetable—the first VFA was not signed until almost a year after Education's scheduled date. Most of the officials from agencies that submitted proposals expressed some dissatisfaction with the delays and the lack of communication from Education about their proposals—especially with respect to how the cost analyses were performed by Education. In addition, program participants other than guaranty agencies said that Education provided them insufficient opportunities and information to examine and comment on the proposed agreements. These participants were also concerned about the absence of a more formal process for determining VFA selection criteria and for inviting VFA proposals.

The VFAs generally complied with most of the legislative requirements. For example, we found that as required by the VFA legislation, the agreements made no changes to the statutory terms and conditions of the loans. However, one of the four agreements does not conform to the requirement that the projected federal program costs not increase due to the agreements. The agreement increased projected costs for the guaranty agency by about $1 million per year—an increase Education considered insignificant when compared with the federal cash flows being estimated. In addition, Education limited the projected cost comparisons of the VFAs to the first 3 years; by doing this, Education concluded that the agreements complied with the statutory requirement that the VFAs not increase projected federal program costs. This may not be a valid conclusion because three of the four VFAs last for an indefinite period of time, and after year 3, Education's analysis showed that projected costs for these agreements would increase substantially.

The key changes implemented under the VFAs include incentive pay structures for guaranty agencies and waivers of certain statutory and regulatory requirements. Each VFA contains provisions for paying the guaranty agency incentive amounts based on specific performance measures, such as default rates. The VFA agencies are establishing programs aimed at enhancing performance to earn incentive payments. The VFAs also waive certain statutory and regulatory requirements for servicing loans and processing claim payments for defaulted loans to test whether alternative processes are more effective. In contrast, guaranty agencies without VFAs do not receive similar incentive payments for improved performance and do not have regulatory requirements waived; however, officials from several of these agencies told us they have efforts under way to reduce defaults.

Education is not fully prepared to assess the effects of VFAs. The agreements went into effect without Education having established a way to adequately measure changes in guaranty agency performance as a result of the VFA through comparisons with past performance and with the performance of other guaranty agencies. For example, Education does not have a way to uniformly measure the net effect of activities such as customer service or agencies' efforts to keep delinquent loans from defaulting. For the latter, a commonly used measure is the "cure rate" (the rate at which guaranty agencies and lenders keep borrowers who are delinquent in their payments from defaulting on their loans). How this measure is calculated currently varies from guaranty agency to guaranty agency. Without uniform measures it would be difficult to distinguish the results of the VFAs from the effects of other factors, such as the general

condition of the economy. The VFA legislation did require that, by September 30, 2001, Education report on the status of the VFAs, including a description of the standards by which each agency's performance under the agreement was assessed and the degree to which each agency achieved the performance standards. However, as of this time, no report had been issued.

We are making recommendations to the secretary of Education to improve the four current VFAs and the development of any additional VFAs. We provided Education a draft of this report for comment. In a letter dated January 23, 2002, Education indicated that they had some concerns about the report. In general, Education had concerns about our characterization of the VFA development process, and our conclusions related to the cost analyses and about the need for additional uniform measures of performance. For example, Education said that in its view the VFAs comply with the requirement that projected federal costs not increase due to the VFAs. We continue to question this view and maintain that a reassessment of projected costs is needed. We discuss these and other comments from Education and where appropriate, we made changes to the report to address Education's comments. (See app. IV for a copy of Education's letter).

Background

The federal government supports two major loan programs for postsecondary students under Title IV of HEA: the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP). In 2000, FFELP and FDLP provided approximately $23 billion and $10 billion, respectively, in loans and loan guarantees to postsecondary students and their parents. Both programs provide subsidized and unsubsidized Stafford loans, Parent Loans for Undergraduate Students and Consolidation loans. Under the FFELP, private lenders, such as banks, provide loan capital. The federal government guarantees the loans but uses 36 guaranty agencies to administer many aspects of the program. With federal funding, these guaranty agencies generally provide insurance to the lenders for 98 percent of the unpaid amount of defaulted loans.[1] The guaranty agencies also work with lenders and borrowers to prevent loan defaults and collect

[1] For eligible loans first disbursed before October 1, 1993, 100 percent of the amount of the loan is insured.

on the loans after default. In contrast, under the FDLP the federal government provides the loan capital to borrowers.

For over a decade, GAO has included student aid programs on a list of "high-risk" federal programs. These programs are designated high-risk primarily because of deficiencies in Education's maintenance of the financial and management information required to administer the student aid programs and the internal controls needed to maintain the integrity of the programs. Over the years Education has addressed many of the high-risk issues identified by GAO; however, these long-standing conditions continue to plague the student aid programs.

To achieve FFEL program and cost efficiencies, and to improve the availability and delivery of loans, the VFA legislation of 1998 authorized VFAs between Education and the state-designated guaranty agencies. The VFA legislation restricted Education to six VFAs through fiscal year 2001, and as of January 2002, Education had entered into agreements with four guaranty agencies. Five other guaranty agencies applied for VFAs but either were not selected or failed to reach agreement with Education (see table 1). Since the beginning of fiscal year 2002, Education has had the authority to enter into VFAs with all of the guaranty agencies.

Table 1: Status of VFA Proposals from the Nine Guaranty Agencies That Applied

Guaranty agency	Status of VFA
Great Lakes Higher Education Guaranty Corporation serving Minnesota, Ohio, Puerto Rico, Wisconsin, and the Virgin Islands	Agreement signed November 27, 2000; effective October 1, 2000
California Student Aid Commission	Agreement signed March 15, 2001; effective January 31, 2001
The Massachusetts Higher Education Assistance Corporation (American Student Assistance) serving the District of Columbia and Massachusetts	Agreement signed March 15, 2001; effective January 1, 2001
Texas Guaranteed Student Loan Corporation	Agreement signed March 15, 2001, effective March 15, 2001, with financial provisions effective October 1, 2000
Pennsylvania Higher Education Assistance Agency serving Delaware, Pennsylvania, and West Virginia	Withdrew application
Colorado Student Loan Program	Selected, but negotiations did not result in an agreement
New York State Higher Education Services Corporation*	Not selected
Illinois Student Assistance Commission*	Not selected
Georgia Higher Education Assistance Corporation	Withdrew application

*The New York and Illinois guaranty agencies submitted a joint application.

In May 1999, Education officials discussed VFAs with guaranty agency representatives who were attending a conference hosted by the National Council of Higher Education Loan Programs, Inc. Two months later, notice of invitation for any of the 36 guaranty agencies to apply for a VFA appeared in the Federal Register. The Register Notice included five "criteria" Education planned to use in its evaluation of the proposals for the VFAs, including (1) how the agency's proposed VFA could be extrapolated and easily used by other FFEL participants; (2) how the proposal would improve the "system" for delivering and servicing of loans for borrowers and schools; (3) if and how the proposal uses new technology; (4) the impact the proposal would have on overall operating costs for the agency and its partners, including Education; and (5) a description of any proposed waiver of the prohibited inducement restrictions (prohibited inducements are efforts by guaranty agencies to encourage schools, borrowers, or lenders to submit applications for loan guarantees through direct or indirect premiums, payments, or, for example, uncompensated services such as loan processing services normally performed by lenders).

VFA Development Process Did Not Fully Meet Participants' Needs

The VFA development process did not fully meet the needs of guaranty agencies and other program participants. Most of the guaranty agency officials we talked to indicated frustration in one or more steps of the process, which began when Education invited all guaranty agencies to submit VFA proposals. Guaranty agency officials were particularly dissatisfied with Education's lack of communication about the VFA development process and its inability to meet its own timetable. Program participants other than guaranty agencies, such as representatives of lender and loan servicing groups, said that the opportunities for examining the proposed agreements were insufficient. Also, these program participants criticized Education for not using a more formal process for determining VFA selection criteria and inviting VFA proposals. In response to these criticisms, Education explained that some of the delay in the VFA development process was the result of broader changes at Education and turnover of key staff assigned to the VFA project. Additionally, Education noted that it had taken extra actions—such as posting the draft agreements to an Internet site—to facilitate public comment on the VFA draft agreements. In commenting on a draft of the report it also noted that some guaranty agencies and other program participants that we consulted had been opposed to the VFA legislation from its inception.

Guaranty Agencies Criticize Education's Efforts during VFA Development Process

According to the guaranty agency officials we talked to, after the invitation process, Education did not communicate adequately with guaranty agencies after failing to stay on schedule. Most of these guaranty agency officials, including those that were generally supportive of Education, expressed a variety of concerns about Education's communication efforts during the VFA development process. For instance, several guaranty agencies indicated a need for more information on Education's methodology for analyzing the projected federal program costs of the VFAs, or on Education's five criteria for selecting the VFAs.

Furthermore, the established timetable was not met. Education indicated it would select the six initial guaranty agencies within two weeks after the application deadline of August 27, 1999, but the notice of selections did not occur until February 2000. Education set December 1, 1999, as the target date for signing the VFAs; however, the first VFA was not signed until November of 2000 and the other three were not signed until March 2001. Guaranty agency officials told us that criticisms of Education's failure to meet its own timetable would have been somewhat mitigated if Education had done a better job in communicating the status of the VFAs to the guaranty agencies. In response to these criticisms, Education officials explained that the process was hampered by organizational

changes and staff turnover that occurred during the VFA development process. For instance, officials told us that delays were partially the result of Education's decision to place a higher priority on developing regulations for implementing other 1998 HEA amendments and on reorganizing the Office of Student Financial Assistance as a performance-based organization.[2] Education officials also indicated that turnover of key personnel assigned to the VFA project as well as disagreements within Education concerning, for example, evaluations of the costs of VFAs contributed to the delays in the VFA development process.

Other Program Participants Also Had Concerns about the Development Process

Although Education provided opportunity for public comment, program participants other than guaranty agencies—for instance, representatives of lender groups such as the Consumer Bankers Association—said these opportunities were insufficient. Education posted each draft agreement for about a 2-week period on the Internet in order to allow interested third parties the opportunity to comment on the agreements. However, some third parties told us that information available on the Web site was insufficient to evaluate the draft agreements and that Education did not provide responses to those who commented on the draft agreements. In response to this, Education officials told us that the Internet posting was not required by the VFA legislation, but that they did so to increase opportunities for public comment. Additionally, Education staff have recently begun meeting with a variety of student loan industry participants to discuss ongoing VFA concerns.

Program participants other than guaranty agencies also criticized Education for not using a more formal process in determining VFA selection criteria and inviting VFA proposals. A couple of third party participants we talked to said the selection criteria should have been developed through a rulemaking process similar to that used to develop federal regulations. Another participant said that VFA proposals should have been solicited through a more formal process, such as those used in federal contracting procedures. According to Education, however, because the agreements were specifically authorized by statute and involved state-designated, not competitively selected, entities, Education

[2]Authorized by the 1998 HEA amendments, the performance-based organization concept creates a "results-driven" organizational structure that uses incentives to encourage high performance while establishing explicit performance objectives to enhance accountability. This approach allows for greater managerial flexibility in an effort to seek innovations and achieve efficiencies.

was not subject to legal requirements applicable to the rulemaking process and that it was not required to use the more formal contracting process.

In commenting on a draft of this report, Education noted that some guaranty agencies and third party program participants had been opposed to the VFA legislation from its inception, and not surprisingly continued to be dissatisfied with the implementation of the VFAs.

Most VFA Provisions Complied with Legislative Requirements; However, Compliance with the Projected Federal Cost Requirement Is Questionable

VFA provisions complied with most of the legislative requirements. For instance, we found that as required by the VFA legislation, the agreements made no changes to the statutory terms and conditions of the loans. However, we were not convinced that the agreements conform to the requirement that the projected program cost to the government not increase due to the VFAs. For one VFA, Education projected federal program costs would increase each year of the 3-year analysis period. Furthermore, the agreements appear to have violated the cost requirement if Education's cost determination had been based on a different time period, or if the analyses had been based on changes in assumptions about certain factors, such as default rates.

The authorizing statute specifies, "in no case may the cost to the Secretary of the agreement, as reasonably projected by the Secretary, exceed the cost to the Secretary, as similarly projected, in the absence of the agreement." Education's budget service analyzed each of the four VFAs in the course of Education's negotiations with the guaranty agencies and concluded that each agreement met the requirement. However, Education's analysis of the Texas VFA projected that federal costs will increase an average of about $1 million a year. Budget service staff indicated that they regarded this amount as insignificant compared with total federal cash flows being estimated. Education's estimates for the Texas agency show that the projected amount of collections on defaulted loans less federal program costs is an average of $161 million per year over fiscal years 2001 to 2003. An alternative basis of comparison could be to use the projected net amount of the agency's receipts from federal sources and its retentions of collections (an average of $71 million per year over the same time period). In either case, the projected increase is not consistent with the VFA legislative requirement that the projected federal program costs not increase due to the VFA.

Our review of Education's analyses raised two additional questions about Education's conclusion that the VFAs would not increase projected federal costs.

Costs considered for first 3 years only. First, Education based its conclusion on projected costs for only the first 3 years, while Education's projections show that costs for three VFAs would increase substantially in years 4 and 5. As table 2 shows, during the first 3 years, only the Texas agreement (discussed above) was projected to cause an increase in federal costs. By including projections for the fourth year or for both the fourth and fifth year, however, costs for three of the four VFAs would rise, with costs for the Texas and Great Lakes guaranty agencies rising substantially. These increases would occur as the size of these guaranty agencies' loan volumes and the cumulative size of their portfolios increase.

Table 2: Education's Projected Increase (Decrease) in Net Federal Program Costs as a Result of Voluntary Flexible Agreements

	Projected cumulative cost increase (decrease) beginning fiscal year 2001		
VFA guaranty agency	**3-year period**	**4-year period**	**5-year period**
California Student Aid Commission	$ 0	$ 0	$ 0
American Student Assistance	$ (122,184)	$ 101,886	$ 259,849
Texas Guaranteed Student Loan Corporation	$ 2,972,499	$ 4,624,526	$ 6,206,608
Great Lakes Higher Education Guaranty Corporation	$ (1,000,000)	$ 5,000,000	$ 11,000,000
Total	**$ 1,850,315**	**$ 9,726,412**	**$ 17,466,457**

Education officials and Office of Management and Budget officials said they took this approach because they viewed the VFAs as demonstration programs of limited duration to be evaluated by the Congress during the next reauthorization of HEA. This act is due for reauthorization at the end of fiscal year 2003. Although the American Student Assistance VFA specifies a termination date at the end of fiscal year 2003, the other three agreements have no specified termination date. They each remain in effect until either the guaranty agency or Education chooses to withdraw with advanced written notice.

Effects of changes in performance not adequately considered. Second, budget service officials reached their conclusions about the cost effects of the VFAs using a set of base year assumptions that did not adequately consider the effect of changes in guaranty agency performance—that is, they assumed that such things as default rates, collection rates, and delinquency rates would remain unchanged in future years. The VFAs were designed to improve guaranty agency performance

and under the agreements, doing so would mean higher payments to the guaranty agencies for their improved performance. Thus, analyzing the proposed payment structures to estimate how such improvements would affect net federal costs—in the form of lower default rates, for example—seems warranted. However, according to budget service officials this happened in only one case and to a limited extent.

In that particular case, budget service staff analyzed the effect of a decline in loan defaults for the California VFA, and its estimates illustrate the importance of considering the effect of changes in guaranty agency performance on federal costs. A provision in the California VFA provides an incentive payment to the guaranty agency for achieving lower default payments. At the time this VFA was being developed Education staff calculated that California's fiscal year 1998 "trigger default rate"[3] –was 3.1 percent compared with the aggregate national rate of 2.9 percent. In an effort to encourage the California guaranty agency to reduce its trigger default rate, the VFA provides for a payment from Education to the guaranty agency equal to half of the amount of claims payments avoided by having a trigger rate below 3 percent. Budget service staff then analyzed the effects of a decline in trigger default rates below 3 percent—to see how much the payment would be in the event the agency was able to reduce it's trigger default rate that much. Education found that the payment to California would be greater than the savings from the reduced defaults—and thus would result in increases in federal costs. However, in doing their formal analysis of the California's VFA, budget service staff did not include the results of their default analysis and instead assumed no change in the base-year 3.1 percent trigger default rate; thus as table 2 shows, there are no projected increases or decreases to the costs for that VFA. Subsequently, California's trigger default rate did drop below 3 percent—down to 2.6 percent for fiscal year 2001. Our analysis based on Education's estimates shows that the California guaranty agency's fiscal year 2001 trigger rate of 2.6 percent entitles it to a VFA incentive payment of about $17.3 million—an amount approximately $2.6 million greater than the estimated total the government saved due to the lower volume of defaulted loans. Because there were no other projected cost

[3] The trigger default rate is used to calculate the level of federal reinsurance payments to guaranty agencies. Higher default rates trigger lower rates of reinsurance payments—payments from Education to guaranty agencies' Federal funds reimbursing them for payments to lenders for defaulted loans. The trigger default rate differs from the more commonly used "cohort default rates," which generally are the rates at which borrowers default on their loans within 2 years of beginning repayment.

considerations for this VFA, the decline in loan defaults under the VFA resulted in an increase in projected net federal costs. Appendix II discusses this analysis in more detail.

Changes Offer Potential for Improved Performance

All four agreements contain provisions for incentive payments for improved guaranty agency performance, and all four grant waivers to certain statutory and regulatory requirements. For the most part these changes are designed to enhance agency performance, such as reduce delinquencies and defaults, while increasing guaranty agency efficiencies. At the same time, however, guaranty agencies without VFAs told us that they have efforts under way to improve their agencies' performance—efforts that did not require the incentive payment structure or waivers granted for the VFA agencies.

Incentive Payments Reward Improved Performance

The VFAs establish incentive payments that reward a guaranty agency for better performance.[4] The use of these incentive payments offers an alternative to the traditional guaranty agency payment structure—a structure some participants describe as containing a perverse payment incentive for the guaranty agencies. Under the traditional payment structure that continues to be used for the non-VFA agencies, it is financially more beneficial for a guaranty agency to allow borrowers to default on their loans and to subsequently collect on the loans than to prevent defaults in the first place. A guaranty agency currently retains 24 percent of the money that it recovers from borrowers whose loans are in default—that is, the borrowers who are more than 270 days behind in making payments. According to some guaranty agency officials, this percentage is typically higher than a guaranty agency's actual cost of collecting on defaulted loans. As a result, a non-VFA guaranty agency has more financial incentive to "allow" borrowers to default than to prevent the default upfront.

Three of the four VFAs have incentive provisions that reduce the guaranty agencies' share of collections on defaulted loans. To compensate for this lower collection retention rate, the VFAs have enhanced incentives for better performance. For example, the American Student Assistance VFA reduces the collection retention rate from 24 percent to 18.5 percent for

[4] The cost of these payments was included in Education's overall cost projections for the VFAs, assuming no change in agency performance.

regular collections on defaulted loans in exchange for potentially greater incentive payments for lower defaults. To implement such incentive provisions, VFA agencies have created programs aimed at improving their performance, particularly in the areas of reducing delinquencies and net defaults. For example:

- To help borrowers with defaulted loans, American Student Assistance created *Bright Beginnings*. This program focuses on providing support to the borrowers and finding solutions to loan default instead of making payment demands and threatening sanctions for nonpayment, such as wage garnishment and negative reports to credit bureaus. Help may involve, for example, working with the borrowers on a strategy to get the education or training necessary to obtain employment that would provide the income needed to repay their loans. Additionally, the program points out to borrowers the advantages of making payments on their loans. For example, if borrowers make nine consecutive monthly payments they will be eligible for rehabilitation, a process by which the guaranty agency sells the defaulted loan back to a lender. Rehabilitation is important because, in addition to being current on their loan payments, the borrowers become eligible for additional Title IV student financial aid.

- To avert defaults by borrowers who withdraw from school without completing their educational program, the California Student Aid Commission is planning an early-withdrawal counseling program. Individuals who withdraw from school early are at high risk of defaulting on their loans and the Commission believes that early intervention by the guaranty agency is more likely to result in the borrowers being able to avoid default. Under current regulations, a guaranty agency provides default aversion assistance to borrowers only after they become 60 or more days delinquent on their loan. Under the early-withdrawal counseling program, the Commission will contact borrowers as soon as they withdraw from school. The program plans to educate borrowers through a variety of services and provide information about their responsibilities and options for avoiding default.

- To help keep delinquent borrowers from defaulting, Great Lakes Higher Education Guaranty Corporation and the Texas Guaranteed Student Loan Corporation are both requiring lenders to submit requests for default aversion assistance between the 60th and the 70th day of

delinquency.[5] Under current regulation lenders can submit requests as soon as the 60th day or as late as the 120th day to submit such a request. Great Lakes and Texas guaranty agency officials believe that by helping to contact delinquent borrowers earlier, they have a better chance to prevent defaults.

Statutory and Regulatory Waivers Are Aimed at Enhancing Guaranty Agency Performance

The statutory and regulatory waivers granted under VFAs attempt to improve guaranty agency performance in two ways—by eliminating duplicate or less effective fiscal, administrative, and enforcement requirements; and by substituting more efficient and effective alternatives. For example:

- The Great Lakes VFA allows for the elimination of some duplicative collection efforts that lenders or loan servicers and the guaranty agency are both required to perform when a borrower became delinquent. Officials from Great Lakes explained that they were concerned that the duplication of effort can be confusing and unnecessarily frustrating to borrowers.

- The American Student Assistance VFA grants authority to replace certain administrative requirements for collection efforts on defaulted loans with new, more targeted approaches. Current regulations specify in considerable detail what collection actions must be taken and during what time periods. For example, after 45 days of delinquency, the guaranty agencies must "diligently attempt to contact the borrower by telephone." Between 46 and 180 days of delinquency, the agencies must "send at least three written notices to the borrower forcefully demanding immediate commencement of repayment." Under the VFA, American Student Assistance has flexibility to develop procedures it considers to be more efficient utilizing best practices common to the financial services industry. Agency officials told us of plans to study borrower behavior to determine the characteristics of borrowers that are most apt to respond to particular default aversion or collection efforts.

Guaranty Agencies without VFAs Also Taking Steps to Improve Performance

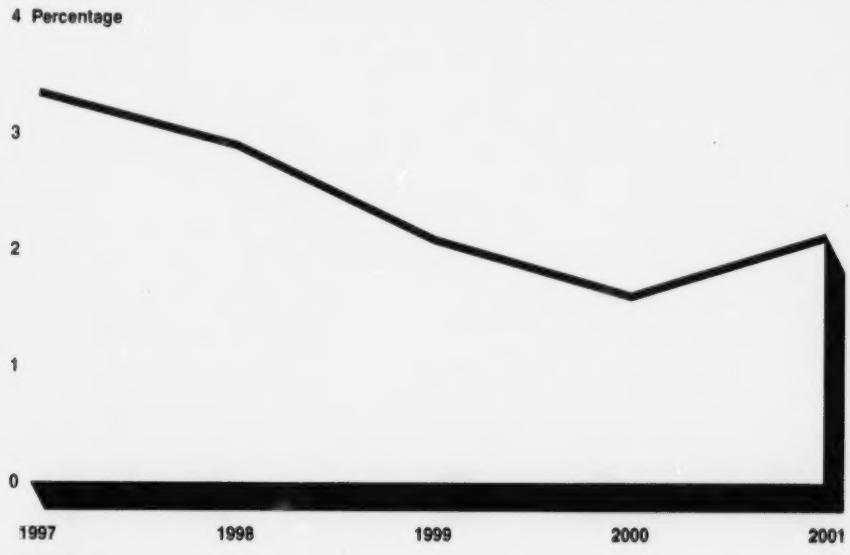
While VFAs represent a new approach to such matters as reducing perverse payment incentives and allowing guaranty agencies to be more innovative in efforts to prevent defaults, they are not the only avenue

[5] The Texas agency allows 5 additional days for receipt of the request by mail.

through which important attempts are being made to seek improvements and innovations in the FFEL program. Guaranty agencies without VFAs are introducing efforts to reduce delinquencies and defaults. Some of the non-VFA guaranty agency officials we contacted indicated that they were uncertain that VFAs are needed in order to improve performance. They believe their mission provides sufficient motivation to increase efforts to prevent defaults by, for example, devoting more resources to work with delinquent borrowers and improving the exchange of information between guaranty agencies, lenders, schools, and Education. They also said that any innovations in customer service could be accomplished under current regulations. For example, the largest guaranty agency, USA Funds, Inc., is working in cooperation with other guaranty agencies on electronic data exchange and electronic signature authority. The agency is also implementing a program to provide students with current and historical student financial aid information from guarantors, lenders, and secondary-markets, as well as to deliver services over the Internet.

For most of the guaranty agencies, the trend in recent years has been a decline in default rates. As figure 1 shows, trigger default rates decreased steadily through fiscal year 2000. The reasons for this reduction are likely multiple, including a low unemployment rate (giving more people jobs to pay off their student loans) resulting from generally favorable economic conditions during that period. Although many observers also credit the decline to the effect of more diligent or effective efforts by guaranty agencies, how much these efforts have contributed is unclear. We were not able to identify any study that has isolated the effects of these influences on default rates.

Figure 1: National Trigger Loan Default Rate* Declined until an Increase in Fiscal



Year 2001.

*The trigger default rate, generally, is the amount of defaulted loans as a percent of the amount of guaranteed loans in repayment. See footnote 3 on page 11 for details.

Education Is Not Fully Prepared to Evaluate VFAS

Education is not fully prepared to evaluate the results of the VFA agreements. The agreements went into effect without Education having developed a clear way to measure changes in guaranty agency performance. For example, Education does not have a way to uniformly measure satisfaction among the agencies' customers. Furthermore, it cannot adequately determine what has happened as a result of the VFAs through, for instance, comparisons with the results of past efforts to cure delinquent loans and comparisons of the results of similar efforts by other guaranty agencies. For the latter, a commonly used measure is the "cure rate" (the rate at which guaranty agencies and lenders keep borrowers who are delinquent in their payments from defaulting on their loans). This measure currently varies from guaranty agency to guaranty agency. It is likely to be difficult to distinguish the results of the VFAs from the effects of other factors, such as the general condition of the economy, but without uniform measures the task becomes even more difficult.

To measure and compare the benefits that result from VFAs, Education needs uniform performance measures. The data Education routinely

collects from guaranty agencies will provide several comparable measures of guaranty agencies' performance, such as certain default rates and the delinquency status of guaranteed loans in repayment.

According to an Education official, Education is working with a consulting firm to develop additional evaluation measures. Additionally, in commenting on a draft of this report, Education noted that it is establishing common measures to evaluate the performance of each VFA. These measures should provide useful data for comparing non-VFA and VFA guaranty agencies. However, other measures of VFA guaranty agency performance might not be as easily compared across the guaranty agencies. For example, Education currently lacks a means of calculating the cost of the VFAs. Specifically, it cannot calculate the amount by which VFA provisions increase federal payments to the VFA agencies, because it does not have a way to determine the amount of default aversion fees[6] that each agency would have received in the absence of the VFA agreements. Also, the Great Lakes guaranty agency plans to measure VFA performance, in part, by measuring customer satisfaction. However, according to guaranty agency and Education officials, no effort is under way to measure other guaranty agencies' customer satisfaction in a similar manner, thus making comparisons difficult.

Another example is the lack of uniformity in calculating a cure rate. Although two of the VFAs specify cure rates as performance measures, these two guaranty agencies calculate cure rates differently and another guaranty agency uses a third method to calculate a cure rate.[7] A uniformly calculated cure rate could be a useful indicator of guaranty agencies' success in preventing defaults for loans that are prone to default

[6] HSA provides for default aversion payments of one percent of the amount of delinquent loans that the guaranty agency helps keep from defaulting. The amounts received by each agency are subject to independent audit requirements and Departmental audit, but Education cannot independently calculate the amounts of the default aversion payments based on data the guaranty agencies routinely provide to Education.

[7] The Great Lakes calculation in based on numbers of accounts cured, not the dollar amounts involved, and the calculation includes delinquent loans for which default is averted whether or not the loan had been cured before. The Texas cure rate is based on the dollar amount of cured loans including loans that had been cured at least 12 months earlier. Texas counts loans as cured as long as they do not result in a default claim by the end of the claim-filing deadline. The guaranty agency with the largest portfolio of loan guarantees, United Student Aid Funds, Inc, calculates cure rates by dividing the number of 60-day-or-more delinquent loans that become less than 60 days delinquent by the total number of 60-day-or-more delinquent loans for which lenders requested default aversion assistance.

(delinquent loans).[8] The current inconsistencies in methods of calculating cure rates make systematic evaluation of VFA results difficult.

The VFA legislation required that Education report on the status of the VFAs, including a description of the standards by which each agency's performance under the agreement was assessed and the degree to which each agency achieved the performance standards. Additionally, Education was required to include an analysis of the fees paid by the secretary, and the costs and efficiencies achieved under each agreement. The report was due no later than September 30, 2001; however, as of this time, no report has been issued.

Conclusions

The VFA development process did not fully meet the needs of the guaranty agencies or other program participants. Despite circumstances at Education that hampered VFA development, such as turnover of key staff, Education might have been able to develop the VFA with fewer frustrations had officials better communicated with participants, particularly with respect to how the cost projections were done. Additionally, a more realistic initial timetable might have lessened some of the criticism from guaranty agency officials.

Education's evaluation of the cost effects of the current agreements raises concerns about whether the federal program costs of current VFAs will grow in the years ahead to the point that they exceed projected costs in the absence of the agreements. In particular, we question the time period Education used for making the cost estimates and the fact that Education did not generally consider potential changes in agency performance for the cost estimates. Although projected cost increases were relatively small in comparison with the total amount of program costs during the first 3 years, estimates for years 4 and 5 showed substantial growth. Also, the general lack of a more thorough analysis of VFA costs—including an analysis of how factors, such as changing default rates might change projected costs—could leave the government vulnerable to greater than projected costs for the VFAs.

VFAs are principally aimed at improving guaranty agency performance through innovative incentive payment structures and in granting waivers

[8] Uniform cure rates could be useful whether or not VFAs specify uniquely calculated cure rates for calculating federal payments.

to statutory and regulatory procedures that might be hampering agency performance. To that end, the VFAs afforded the guaranty agencies the opportunity to try new ways of operating. Whether the incentive payments and waivers used by the VFA agencies improve guaranty agency performance more than the self-initiated efforts of the non-VFA agencies remains to be determined.

Measuring the benefits of the VFAs is central in deciding if more VFAs should be entered into and if current VFA practices should be replicated at other guaranty agencies. We found that Education is not fully prepared to evaluate the success of VFAs in part because it does not have adequate standardized performance measures, such as delinquent loan cure rates. Without adequate performance measures Education is not well positioned to judge the success or failure of the VFA provisions.

Recommendations for Executive Action

To improve the VFA development process for any future VFAs, we recommend that the secretary of Education develop

- a plan to more regularly communicate with guaranty agencies concerning the status of VFA development efforts, including disclosing to program participants the planned methods for projecting the federal program cost effects of VFAs; and
- a timetable for selection, negotiation, and completion of agreements based on experience developing the first four VFAs.

In order to ensure that all VFAs are in compliance with statutory requirements, we recommend that the secretary of Education

- renegotiate the Texas VFA as soon as practicable to obtain changes necessary to ensure that the VFA does not increase projected federal costs;
- renegotiate the California VFA as soon as practicable to obtain changes necessary to ensure that the VFA does not increase projected federal costs, with or without changing the trigger default rate;
- renegotiate the Great Lakes and American Student Assistance VFAs for time periods after fiscal year 2003 to ensure that the VFAs do not increase projected federal program costs; and
- improve projections of the cost effects of renegotiated VFAs and any future VFA proposals by (1) requiring that each VFA specify an

effective time period, (2) conducting a cost analysis covering that period, and (3) conducting analyses to project the cost effects of changes in assumptions regarding guaranty agency performance, such as default rates, in making the cost projections.

To ensure that the results of the VFAs can be effectively evaluated, we recommend that the secretary of Education

- develop specific evaluation plans enabling Education to compare VFA guaranty agency performance with past performance and the performance of other guaranty agencies using uniformly defined performance measures, including delinquent loan cure rates.

Agency Comments

We provided a draft of this report to Education for comment. In its response, Education indicated that it had a number of concerns about the report.

Education stated that our mention of GAO's designation of the student financial assistance programs as "high-risk" (in the Background section) was beyond the scope of our review and that it detracts from the analysis in the report. We disagree. The report contains analyses and descriptive information on many aspects of the FFEL program, which provided approximately $23 billion of loans for postsecondary students in fiscal year 2000. The mention of the student loan programs as high risk and the ensuing discussion are important to help establish the significance that any changes—including the VFAs—might have on the program.

Regarding the development of the VFAs, Education said that it appears that our conclusions were based primarily on conversations with individual guaranty agencies that did not apply for a VFA and representatives of various interest groups, many of which had consistently opposed the VFAs. In fact, as indicated in our report, our conclusions are largely based on comments from representatives of 18 guaranty agencies—including representatives from all four agencies with VFAs; representatives from those agencies that had unsuccessfully sought a VFA; representatives from agencies that did not seek a VFA, but may wish to in the future; and representatives from agencies that had opposed the VFA legislation from the beginning.

Concerning the cost effects of the VFAs, Education stated that it had, in keeping with its standard procedures for estimating costs, (1) used a closed time period (in this case, 3 years) to project costs; (2) not

considered the impact of possible changes to borrower or institutional behavior in projecting costs; and (3) appropriately treated the $1 million per year projected cost increase for the Texas VFA as "insignificant."

First, in looking at the 3-year time period, Education said that its conclusions about the cost effects of the VFAs were appropriately limited to the first 3 years because there was no reason to expect that the agreements would necessarily remain in effect beyond the time period for reauthorization of HEA, which may bring changes that could alter any cost analyses. We agree that the projected increases in federal costs in the fourth and fifth years would not be relevant if the current agreements no longer remain in effect after the end of fiscal year 2003. However, since three of the VFAs are open-ended, there is reason to believe they could extend beyond three years. Therefore, to ensure that projected federal costs do not increase due to the VFAs, Education would need to renegotiate the VFAs for the time period beyond 3 years. Education's statement that, "GAO's interpretation of the statute as requiring strict 'cost neutrality' over a long period of time is not supported in the statute or the legislative history," is incorrect. We did not interpret the statute in this manner. Instead, our reading of the statute is that the period of time to be examined should correspond to the projected life of the agreement. As mentioned above, three of the agreements we reviewed were for an open-ended period of time. Education chose a 3-year period for their cost analysis, which is within its discretion and not inconsistent with the statute. However, the report was intended to make clear that, given the open-ended nature of the agreements, a decision by Education not to terminate the agreements after 3 years would warrant a reassessment of the cost projections and a renegotiation of the agreements, if necessary.

Second, Education stated that it does not base cost estimates on behavioral assumptions that cannot be supported by available data. We agree that this is appropriate for baseline estimates, however one of the purposes of the VFAs is to improve guaranty agency performance, and thus the cost effects of potential improvements need to be considered in Education's cost projections. Accordingly, we recommended that Education supplement baseline estimates with sensitivity analyses in order to avoid provisions that increase federal costs when an agency's performance improves, by reducing default rates for example.

Third, with respect to Education's assertion that the projected increase of $1 million per year for the Texas VFA is "insignificant," we disagree. Education based its assertion on a comparison of the $1 million to the total federal cash flows being estimated. The projected amount of

collections on defaulted loans less federal program costs averaged $161 million per year for the 3-year period—an amount lower than the "hundreds of million of dollars per year" Education cited in its comments. Additionally, an alternative basis of comparison could be to use the projected net amount of the agency's receipts from federal sources and its retentions of collections (an average of $71 million per year for the 3-year period). In either case, the projected increase is not consistent with the VFA legislative requirement that the projected federal program costs not increase due to the VFAs.

Regarding preparations to evaluate the VFAs, Education said that it is establishing common, general measures to evaluate the performance of each VFA and, whenever possible, to compare VFA guaranty agency performance with other non-VFA guaranty agencies. Education noted that it has had preliminary discussions with representatives of the 36 guaranty agencies regarding uniform performance measures. Also, it noted that the guaranty agencies are in the process of establishing an eight-member task force to assist in determining the specific formulae for measuring VFA performance. As our report indicates, Education does currently have several possible uniform measures of agency performance. We welcome its efforts to develop additional measures, but conclude that a uniform cure rate measure would assist in evaluating the performance of the VFAs, considering that two guaranty agencies with VFAs specifically identified a cure rate as a performance indicator.

We reviewed these and additional Education comments and modified the draft as appropriate. Education's comments are included in appendix IV.

We are sending copies of this report to Honorable Roderick R. Paige, secretary of Education; appropriate congressional committees; the guaranty agencies with VFAs; and other interested parties. Please call me

at (202) 512-8403 if you or your staff have any questions about this report. Key contacts and staff acknowledgements for this report are listed in appendix V.

Sincerely yours,

Cornelia M. Ashby

Cornelia M. Ashby
Director, Education, Workforce,
and Income Security

Appendix I: Scope and Methodology

As agreed with your office, we focused our review of voluntary flexible agreements (VFA) on addressing the following questions:

1. To what extent did the VFA development process meet the needs of guaranty agencies and other program participants?

2. To what extent do VFAs comply with requirements in the VFA legislation?

3. What changes are being implemented under the VFAs?

4. How well prepared is Education to assess the effects of the VFAs?

To determine the extent to which Education's VFA development process met the needs of guaranty agencies and other program participants, we interviewed Education officials involved in the development of the VFAs, officials at each of the nine guaranty agencies that submitted an application for a VFA, and nine guaranty agencies that did not submit applications. The nine guaranty agencies that did not submit applications included the five guaranty agencies with the largest amounts of loan guarantees and four randomly selected smaller guaranty agencies that did not submit applications.[1] We also reviewed VFA proposals and comments Education received during the public comment period.

To determine the extent to which the VFAs complied with statutory requirements we reviewed the VFA agreements, provisions of the Higher Education Act (HEA) concerning the Federal Family Education Loan Program (FFELP), and related regulations. We also discussed the agreements with Education and guaranty agency officials, and representatives of industry associations including the National Council of Higher Education Loan Programs, Inc. and the Consumer Bankers Association. To review Education's methods for projecting the costs of the VFA agreements, we examined computerized schedules Education used to project each VFA guaranty agency's costs and financial data compiled by Education staff from submissions by the guaranty agencies. We also discussed these projections with Education's budget service staff and Congressional Budget Office and Office of Management and Budget officials.

[1] One of five smaller guaranty agencies selected did not respond to GAO request for input.

To identify changes being implemented under the VFAs we reviewed the VFAs and discussed them with the guaranty agency officials and reviewed documents they provided concerning their programs.

In addition, to determine how well prepared Education is to identify the effects of the VFAs, we discussed plans for evaluation of the VFAs with guaranty agency officials and Education officials responsible for collecting and analyzing data from guaranty agencies.

Appendix II: Comparison of Projected Federal Costs with California Trigger Default Rate at 2.6 or 3 Percent

On the basis of budget service subsidy rate estimates, we projected the level of noninterest federal costs for $263 million of loans—the amount of loans that would default if the California guaranty agency's trigger default rate[1] were 3 percent in fiscal year 2001. As shown in table 3 below, we estimated the net federal costs of these loans (excluding interest subsidy costs that the budget service indicated would not be affected) under four different scenarios: (1) a 3 percent trigger default rate with all $263 million of these loans defaulting without the VFA in effect, (2) a 3 percent trigger default rate with the VFA in effect, (3) a 2.6 percent trigger default rate with $228 million of the $263 million of loans defaulting without the VFA in effect, and (4) a 2.6 percent trigger default rate with the VFA in effect. As shown in table 3, federal noninterest costs for these loans would be about $107 million under either scenario 1 or scenario 2. In scenario 3, federal costs would decline by about $15 million to $92 million as trigger basis defaults decline from 3 percent to 2.6 percent.

Under scenario 4, however, Education would benefit from lower loan defaults, but it would also have to pay the California guaranty agency half of the $34.7 million reduction in the amount of claims payments to lenders (a $17.3 million VFA fee). Because the VFA fee exceeds the benefit Education would realize from the lower level of defaults, federal costs would increase by an estimated $2.6 million.

[1] The trigger default rates are calculated by dividing the total annual amount of reinsurance payments for defaulted loans (adjusted for loans brought back from default into repayment status) by the original principal amount of loans in repayment at the end of the preceding fiscal year.

Table 3: Estimated Present Value Noninterest Federal Costs for California Loans That Would Default at a 3 and a 2.6 Percent Trigger Default Rate in Fiscal Year 2001-

Millions of dollars[a]			
At a 3.0 % trigger default rate[b]	**Without VFA–scenario 1**	**With VFA–scenario 2**	**Difference**
Net default costs[c]	$111.3	$111.3	$ 0.0
VFA fee for default rate below 3 percent[d]	Not applicable	0	0.0
Default aversion fees[e]	0	0	0.0
Account maintenance fees[f]	1.2	1.2	0.0
Other[g]	(5.7)	(5.7)	0.0
Total[h]	**106.8**	**106.8**	**0.0**
At a 2.6 % trigger default rate[b]	**Without VFA–scenario 3**	**With VFA–scenario 4**	**Difference**
Net default costs[c]	96.7	96.7	0.0
VFA fee for default rate below 3 percent[d]	Not applicable	17.3	17.3
Default aversion fees[e]	0.3	0.3	0.0
Account maintenance fees[f]	1.4	1.4	0.0
Other[g]	(6.3)	(6.3)	0.0
Total[h]	**92.1**	**109.4**	**17.3**
Increase (decrease) in costs due to decline in trigger default rate from 3 percent to 2.6 percent	**$(14.7)**	**$2.6**	**$17.3**

[a]The present value of a series of future payments is the sum of the payments, with each payment discounted by an appropriate interest rate over the number of years in the future that payment occurs. Budget service estimates indicate that interest costs, including interest benefits covering students' share of interest while in school and during the grace period, would be the same with or without the VFA. These estimates are based on budget service subsidy calculations in March 2000 using a 6.77 percent discount rate. As of March 2000 the applicable discount rate for FY 2001 was 6.25 percent. The use of a lower discount rate would result in lower subsidy rates for defaulted loans, as collections in the future would be discounted at a lower rate. Although the budget service subsidy estimates upon which these estimates were based were calculations for subsidized Stafford loans (loans for which the federal government rather than the borrower bears interest costs while the student is in school and during a grace period), budget service staff explained that the subsidy rates for other loan types would be similar apart from the interest subsidy costs. The figures shown are expressed in present value terms as of FY 2001 and the calculations reflect adjustments for the effect of loan cancellations.

[b]A 3.0 percent trigger default rate in fiscal year 2001 would correspond to net default claims of $263 million. A 2.6 percent rigger default rate would correspond to net default claims of $228 million.

[c]Net default costs are the federal costs associated with default adjusted for the present value of subsequent collections on the loans.

[d]The VFA fee is calculated based on a provision in the California VFA agreement. Budget service staff estimated that none of the California VFA provisions would change federal program costs under baseline conditions assuming that the guaranty agency's trigger default rate remained above 3 percent.

[e]Guaranty agencies receive a default aversion fee equal to 1 percent of the principal and interest amount of delinquent loans for efforts to prevent defaults. Amounts of any loan defaults are deducted from these payments.

[f]Guaranty agencies receive from Education account maintenance fees equal to 0.1 percent of the original principal amount of outstanding loans guaranteed. These fees are not paid on loans for which the guaranty agency has paid default claims.

[5]Other costs include origination fees and federal payments for death, disability, and bankruptcies.

[6]The totals may not be equal to the sum of items shown due to rounding.

The VFA default rate incentive payment, one-half of the claims payments avoided with a trigger default rate below 3 percent, was identified in the VFA agreement as "50% of the savings in claim payments resulting from its default aversion activities under this VFA." This calculation, however, fails to take into account two potentially significant factors. First, the federal cost of loan default is mitigated in part by subsequent collections on the defaulted loan. If the guaranty agency receives payment on a loan after the loan defaults it generally is allowed to retain 24 percent of the amount collected.[2] The remaining 76 percent must be remitted to Education. Budget service staff looked to see how the present value of these payments would affect the present value of program costs for Subsidized Stafford loans. They concluded that the federal cost (aside from federal administrative costs) on a subsidized Stafford loan that defaults is on average about 47.5 percent of the amount of the loan. The comparable figure for the same loan without default, but with the VFA incentive payment was 51.7 percent. In other words, the incentive payment to California's guaranty agency exceeded the present value of the federal cost of the default adjusted for the subsequent collections on the loan. Instead of benefiting from fewer defaults of loans guaranteed by the California guaranty agency, Education stands to benefit from increases in defaults until the guaranty agency's trigger default rate reaches 3 percent. Above that point the guaranty agency would not receive an incentive payment and Education would not benefit from higher levels of defaults.

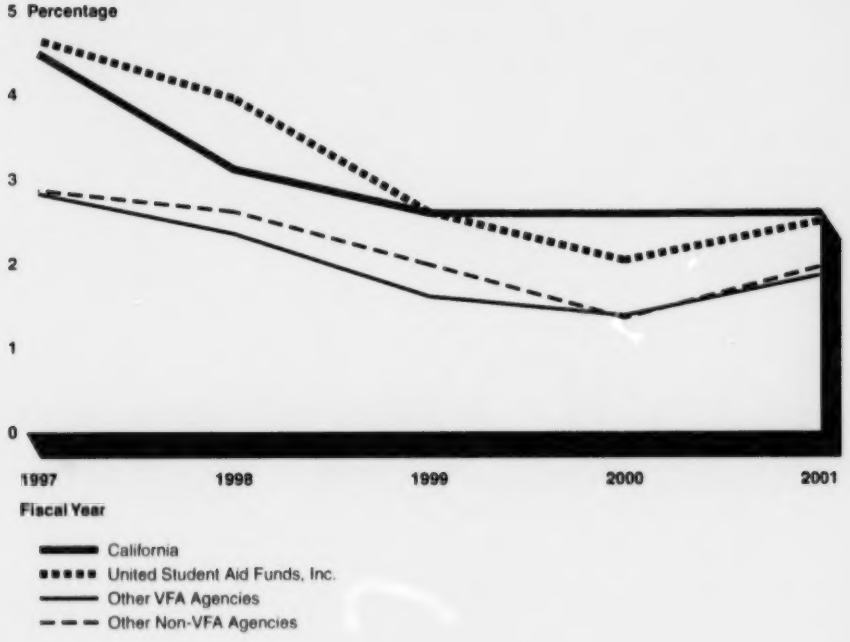
The second reason for questioning the provision's definition of federal cost savings resulting from the VFAs default aversion activities is that the entire decline in default costs may not be solely attributable to the VFA. Default rates change for many reasons. According to guaranty agency and Education officials, declines in default rates are due to such factors as a change in definition of default from 180 to 270 days of delinquency brought by the VFA legislation, increased default aversion assistance activities by all guaranty agencies, enhancements in loan servicing methods, and a prosperous economy. The VFA incentive payment to

[2] The Higher Education Act provides that this retention rate will decline to 23 percent after fiscal year 2003. If a defaulted loan is consolidated in the form or either a FFELP or a FDLP consolidated loan, the agency may retain 18.5 percent.

California rewards the guaranty agency for any decline in default rates whether it is due to VFA prompted efforts or to other factors.

As shown in figure 2 below, generally guaranty agencies have seen declines in trigger default rates. Guaranty agencies that received VFAs and guaranty agencies that did not both saw declines in default rates from fiscal year 1997 to fiscal year 2000, with increases in fiscal year 2001. For example, the largest guaranty agency, USA Funds, Inc. had a higher default rate than California's in fiscal years 1997 and 1998. However, by fiscal year 2001, its default rate was slightly lower than California's.

Figure 2: VFA and Non-VFA Guaranty Agencies Experienced Trigger Default Rate Declines through 2000



Appendix III: Summary of VFA Financial Provisions

Table 4: Summary of VFA Financial Provisions

	California	Massachusetts	Texas	Wisconsin	Guaranty agencies without VFAs
Place federal reserve funds in escrow and receive reimbursement for 100% of claims payments	No	Yes	Yes	Yes	No
Loan Processing and Issuance Fee	Yes	Yes	Yes	No[a]	0.65% of net commitments to 0.4% in 2004
Account Maintenance Fee	Yes	No	Yes	No[a]	0.1% of the original principal amounts of all outstanding guarantees
Default Aversion Fee	Yes[b]	No	Variable	No[a]	1% of principal and interest on cured loans, but only once per loan

	California	Massachusetts	Texas	Wisconsin	Guaranty agencies without VFAs
Guaranty agency Share of Collections	Variable	18.5% on regular collections, rehabilitated loans and consolidations of delinquent and defaulted loans	Variable	Equal to collection cost	24%; 23% beginning in FY 2004; 18.5% for rehabilitated loans and consolidation of defaulted loans
New ED payments to guaranty agencies with VFAs	50% of claims savings if trigger rate is below 3%	Wellness fee calculated as a percentage of the amount of loans not delinquent; base fee equal to 22 basis points; variable fee equal to 0.25 basis points for each percentage point improvement in defaults relative to national trigger default rates	Default aversion fee from 1.25% to 4% depending on performance	Performance fee based on cure rate from 25.9 to 31.9 basis points of the original principal amount of guaranteed loans	Not applicable
	If the California guaranty agency's collection rate exceeds the national average it receives the normal retention percentage plus a percentage equal to the percent improvement in its collection recovery rate	Reduction in wellness fee for poorer than specified accuracy in data provided to the National Student Loan Data System	Guaranty agency share of collections varies with the recovery rate; 19.5% to 23% for regular and 18.5% to 20% for rehabilitation and consolidations Delinquency prevention fee; 0.05% to .12% of loans in repayment w/o default aversion request		

[a]Components of the performance fee for Great Lakes have these labels, but they are computed differently under the VFA.

[b]California's guaranty agency receives a default aversion fee when the borrower begins receiving early separation counseling with or without delinquency

Appendix IV: Comments from the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

THE DEPUTY SECRETARY

January 23, 2002

Ms. Cornelia Ashby
Director, Education, Workforce,
and Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Ashby:

I am writing in response to your request for comment on the draft GAO report to Senator Jeffords on the Voluntary Flexible Agreements (VFAs) between the United States Department of Education (ED) and certain guaranty agencies in the Federal Family Education Loan (FFEL) program. The draft report is entitled, "Federal Student Loans: Flexible Agreements With Guaranty Agencies Warrant Careful Evaluation." We have a few concerns with the report, as discussed below.

COVER LETTER AND BACKGROUND

As you note in your cover letter to Senator Jeffords, the relationship between ED and state-designated guaranty agencies that administer the nation's federally supported student loan program is changing. In fact, that relationship has been changing since the mid-1980s and will continue to change as every administration attempts to achieve program and cost efficiencies and improved student aid delivery. During the 1990s, both The Student Loan Reform Act of 1993 and The Higher Education Amendments of 1998 (HEA Amendments) significantly changed the existing relationship between ED and guaranty agencies. The Student Loan Reform Act created a new loan program in direct competition with the FFEL program, while the HEA Amendments established a new method for paying guaranty agencies for services rendered. In addition, the HEA Amendments gave ED the opportunity to test, through the use of VFAs, new and innovative methods for carrying out the types of activities currently required of guaranty agencies. After careful evaluation and rather lengthy negotiations, ED and four guaranty agencies entered into VFAs. Careful evaluation of the outcomes attributable to the VFAs will be a priority of ED as we prepare for the reauthorization of the Higher Education Act (HEA).

The "Background" section of the draft report discusses the student financial assistance programs' placement on the GAO "high-risk" list. Although resolving the issues that placed the student financial assistance programs on GAO's high-risk list is a high priority for the Secretary, the high-risk issue is well beyond the scope of the report as described by GAO and only detracts from the analysis contained in your report.

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Page 2 – Ms. Cornelia Ashby

VFA DEVELOPMENT

GAO states that the VFA development process did not fully meet the needs of the guaranty agencies or other program participants. It appears that GAO came to this conclusion based primarily on conversations with individual guaranty agencies that did not apply for a VFA and representatives of other program participants. However, the report fails to acknowledge that many of these individual agencies and other program participants opposed the VFA concept from its inception. Based on that knowledge, no one should be surprised that these same parties were dissatisfied with many aspects of the process as well as the results. Although not required, ED gave all guaranty agencies, lenders, and other program participants a significant opportunity for participation, including a specific opportunity to review and comment on all the draft agreements.

Complaints about delays in the process are understandable. It did take a long time to evaluate and analyze proposals and negotiate final agreements. However, ED was concerned about selecting valid proposals that met the legislative requirements. Your report notes that most VFA provisions complied with the legislative requirements so I believe the extra time devoted to the process was not wasted.

In addition, ED recognized that implementing a new concept like the VFAs would be of great interest to participants in the student loan program. On its own initiative, ED invited public participation in the process. ED provided this opportunity for review and comment even though the agreements between ED and the selected guaranty agencies were not subject to the legal requirements applicable to the rulemaking process. If the VFA negotiations had been subject to standard rulemaking procedures, as some groups would have liked, there would have been further delays, and it is very possible that the primary goal of providing useful information for the upcoming reauthorization of the HEA would not have been met.

COMPLIANCE WITH FEDERAL COST REQUIREMENT

GAO's primary criticisms regarding the VFAs relate to ED's compliance with legislative requirements related to cost estimation issues. Specifically, GAO is concerned that (1) ED only considered costs for the first three years of the VFA; (2) changes in behavior may alter costs; and (3) ED did not consider projected increased federal costs of $1 million as significant. We believe the cost estimations for each VFA comply with the legislative requirements.

ED projected the cost to the government associated with each agreement. The cost projections included a federal cost summary for each agreement as well as more detailed tables showing projected cash flows for specific agency operating revenues and expenses under the current and proposed agreements. Under these projections, ED determined that none of the agreements would exceed the cost under the standard guaranty agency model.

The statute requires the Secretary to "reasonably project" the costs of each VFA. In making these projections, ED used cost estimation rules it consistently applies in other budget analysis situations: it used certain closed periods (in this case, 3 years) to calculate costs; it did not treat insignificant federal costs as violating cost neutrality requirements; and it did not consider the impact of changes in behavior in calculating costs. It is certainly reasonable for ED to apply these general rules to this situation.

With respect to the period of time considered, three years is consistent with ED's understanding of the goals of the statute. That is, the VFAs would be evaluated to inform the next reauthorization of the HEA, and possible changes at that time would significantly alter any cost analyses of the agreements. Using longer time horizons would have been incorrect in this case since there was no reason to expect that the agreements would necessarily remain in effect beyond the reauthorization time period. GAO's interpretation of the statute as requiring strict "cost neutrality" over a long period of time is not supported in the statute or the legislative history.

With regard to GAO's comments on the effect of behavioral changes, ED does not base its cost estimates on behavioral assumptions that cannot be supported by available data. In the absence of any supporting evidence, ED assumes that current trends in borrower and institutional behavior will continue. Under these assumptions, ED's cost estimate of the California VFA is cost neutral and in compliance with statutory requirements.

Finally, in the case of the Texas VFA cost estimate, the increase in cost (roughly $1 million per year) was compared to the total federal cash flows being estimated (hundreds of millions of dollars per year) and was judged to be insignificant from a statistical point of view. This type of judgment is a routine aspect of cost estimation in which uncertainty with regard to future events plays such a large role.

EVALUATION OF THE VFAs

GAO states that ED "cannot determine what has happened as a result of the VFA through, for instance, comparison with past performance and comparisons with the performance of other guaranty agencies."

ED is establishing common, general measures to evaluate the performance of each VFA and, whenever possible, to compare VFA guaranty agency performance with other non-VFA guaranty agencies. These measures include:

- Analyzing the dollar percentage of loans in good standing in order to determine the success of a guaranty agency's ability to decrease defaults.
- Determining guaranty agency effectiveness in collections recoveries in order to monitor the guaranty agency's ability to recover funds from its defaulted loan portfolio.
- Assessing the ability of guaranty agencies and ED to effectively administer the guaranty agency program without guaranty agency reserves.

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- Measuring the fees that would have been paid under the standard guaranty agency model versus the fees that are paid under the VFAs.
- Monitoring the percentage of National Student Loan Data System records entered correctly by the VFAs as a percentage of the total number of possible entry records in order to measure data integrity.

In order to provide a basis for evaluating the performance of the VFA guaranty agencies under the agreements, the performance measures will be compared to benchmark information. For example, the measure of the dollar percentage of loans in good standing as of a certain date does not provide much interpretative value by itself. The performance measure, instead, will be compared to the VFA guaranty agency's prior period percentage in order to assess whether the VFA guaranty agency's performance has improved or deteriorated. To the extent possible, the VFA guaranty agency's results will be compared to the other VFA guaranty agencies as well as to the non-VFA guaranty agencies.

ED will determine whether the terms and conditions established in each VFA process are scalable and transferable to the wider FFEL community. Additionally, ED will consult lenders and schools participating in each guaranty agency's program to determine how they are affected by VFAs. ED will also consult with guaranty agencies that are not participating in a VFA to determine if the agreements have had an adverse impact on other guaranty agencies.

ED has had preliminary discussions with representatives of the 36 guaranty agencies regarding the uniform performance measures. Further, the guaranty agencies are in the process of establishing an eight-member task force that includes VFA as well as non-VFA guaranty agencies to assist in determining the specific formulae for measuring VFA performance. As these discussions progress, ED and the guaranty agencies will be in a better position to determine what measures require government mandates.

As noted in the report, the four VFAs currently in place offer the potential for improved performance. If they lead us to more efficient and effective methods for managing the student loan program, the project will have been a success as envisioned in the HEA Amendments.

Thank you for this opportunity to comment on the draft report on voluntary flexible agreements.

Sincerely,

William D. Hansen

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to the individuals named above, Jonathan H. Barker, Daniel R. Blair, Christine E. Bonham, Richard P. Burkard, Timothy A. Burke, Aaron M. Holling, Stanley G. Stenersen, and James P. Wright made key contributions to this report.

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